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Unentrapped

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Response

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In *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*,[1] Professor Robert Ahdieh bids us to clean up corporate federalism. We should stop describing the states as "racing" to make corporate law and stop evaluating the results of state lawmaking as a binary choice of "top" or "bottom." We should also stop imposing determinative presumptions favoring state or federal regulation, and instead grapple with institutional advantages and disadvantages of regulation at different levels of government as cases arise. This is good advice. But I am hardly the person to gainsay it, having been giving the same advice for a decade and a half.[2]

For me, then, the interest in Professor Ahdieh's paper lies in the theoretical review and restatement that leads up to these sensible con-

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1 Robert B. Ahdieh, *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*, 77 GEO. WASH. L. REV. 255 (2009).

2 William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401 (1994); William W. Bratton, *Delaware Law as Applied Public Choice Theory: Bill Cary and the Basic Course After Twenty-Five Years*, 34 GA. L. REV. 447 (2000); William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 NW. U. L. REV. 181 (1992); William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861 (1995) [hereinafter Bratton & McCahery, *Regulatory Competition*]; William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism*, 41 WAKE FOREST L. REV. 619 (2006); William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201 (1997).

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clusions. This discussion begins with a rumination on Ralph Winter's urtext on charter competition.[3] Subsequent corporate federalists, says Professor Ahdieh, have gotten Winter wrong. They see Winter as focused only on states competing for corporate charters, where Winter in fact considered the charter market in a broader context of competitive constraints imposed by capital markets, product markets, and the market for corporate control. Later readings of Winter, says Professor Ahdieh, wrongly collapse the broader market constraints into the narrower charter market, employing the following logic: the charter market makes the states sensitive to corporate managers; the capital, product, and control markets force the managers to be sensitive to the shareholder interest; therefore, the charter market makes the states sensitive to the shareholder interest. This deductive conclusion, it is argued, does not follow from the Winter description. State corporate law, while competitively driven, responds only to the managers who make the chartering decisions. State law accordingly cannot provide an efficient solution to the problem of separated ownership and control. Such a solution, which Professor Ahdieh poses as a goal of efficient corporate governance (as opposed to efficient corporate law), would depend in turn on capital market (as opposed to charter market) constraints. If capital markets are efficient, corporate governance will be efficient; if capital markets are inefficient, so too will corporate governance be inefficient even though the charter market may be efficient.

It follows that the charter market does a less effective job than that claimed by its federalist boosters. Even so, says Professor Ahdieh, it holds out a pair of benefits. First, it provides managers with the flexible rules they demand, rules that lower the cost of meeting shareholder demands. Second, because it holds out the possibility of exit through reincorporation, it checks regulatory rent seeking and thereby enhances the surplus created by the firm. It does not follow, however, that federal intervention into corporate internal affairs is necessarily a bad thing. Since the state system neither succeeds in resolving the problem of separated ownership and control nor succeeds in resolving attendant matters of power allocation and distribution, federal intervention could be justified, provided that the particulars of the case held out an efficiency improvement and the political context holds out no risk of interest group rent seeking.

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3 Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

Professor Ahdieh's thesis, thus restated, is robust. It is an accurate description that successfully negates the proposition that charter competition leads to an efficient corporate governance system. The negative, as Professor Ahdieh acknowledges, less concerns corporate law itself than academic discussions thereon. The point is well-taken—something went wrong with this discourse, and I happily would ramp up the criticism. Continued focus on the charter market has prompted a generation of academics to engage in an intricate discussion of charter competition's institutional context, variously showing how it does or does not mimic the incidents of a robust market for widgets. All assume that a showing of similarity or dissimilarity has momentous consequences, similarity implying efficiency and dissimilarity implying inefficiency. Like Professor Ahdieh, I find the whole discussion somewhat beside the point, wondering why anyone would expect a law market closely to resemble a product market in the first place, particularly given that no one familiar with the economics of regulatory competition would ever form such an expectation.

At the same time, I do not think that corporate law's focus on charter competition does any particular harm. Those who spend energy in highlighting the market's flaws, while "trapped in the metaphor," at least counterweigh the efficiency claims of the federalists. Moreover, the granular description of the charter market that emerges teaches us things about the properties of law as product, even if it has limited normative implications for corporate law.[4] So far as I can see, the only people locked in by the corporate federalism perspective challenged in the article are its own exponents. Any negative effects accordingly fall solely upon them, in the form of increasing irrelevance over time.

At the same time, academic discourse on corporate law, including discourse on corporate federalism, is considerably more robust than a reader of the article might conclude. Consider, first, federalism discussions. Even as these tend to focus on comparisons between the charter market and conventional product markets, they are not thereby limited. The literature yields a description of federal-state relations that is considerably more nuanced and instructive than an off-the-rack either/or based on first generation public choice theory.[5] Nor

4 The initial contribution to this literature, Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987), remains to my mind the most compelling.

5 The leading exemplar is Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003), which situates Delaware in a national context of interest group conflict.

are discussions of institutional design limited to narrow mandatory or enabling federal-state comparisons. Some step outside of the box to ask whether there is a correctable flaw in the charter market's structure. These interventions start with the point that the charter market tends to cater to management preferences and suggest that it accordingly makes sense to consider whether the market could be redesigned so as to open a path to capital market inputs and thereby move corporate law in a more responsive direction. Professor Ahdieh rightly chides charter market advocates for stonewalling at this point. A new design would have to be federally mandated, and their federalism forecloses such a possibility on a *per se* basis, even as these advocates number among the critics of the antitakeover regulation that results from the market's responsiveness to management preferences. But this theoretical stone wall has not prevented critics from confronting and rejecting the Hobson's choice posed. Joe McCahery and I made a narrowly tailored proposal for shareholder access to amend corporate charters to change the state of incorporation, positing that the charter market thereby could extend its reach to the problem of separated ownership and control.[6] Lucian Bebchuk and Allen Ferrell followed up with a broader proposal keyed to the reversal of state antitakeover barriers.[7]

Federalism discussions in any event occupy a secondary place in the wider corporate law scheme of things. Corporate law debates center on three overlapping topics: (1) the appropriate scope of regulation and the degree of reliance accorded state authority or, alternatively, private ordering, in organizing firms and solving problems; (2) the boundaries of the firm and the firm's responsibility to outsiders; and (3) the terms of the corporate agency relationship and the allocation of authority within the firm. Federalism intersects all three, but in an instrumental posture.

The Cary-Winter debate concerned the first topic. Bill Cary, following Adolf Berle, favored strong fiduciary prohibitions over self-dealing by managers and control parties, and thus favored legal mandate over private ordering in the structure of corporate law.[8] Because competitively driven state law did not impose the mandates he advo-

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6 Bratton & McCahery, *Regulatory Competition*, *supra* note 2.

7 Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001).

8 *See* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 700–01 (1974).

cated, he saw a race to the bottom.[9] Winter reversed the race's outcome because he thought that private ordering imported adequate protection.[10] Either way, the bottom-line question went to the level of fiduciary constraint, with federalism positions following from conflicting views over the efficacy of mandates and private ordering.

The second topic pits progressive advocates of constituency rights and corporate social responsibility against the corporate law status quo. Here, the federalism intersect is largely beside the point. State corporate law invites externalities by granting limited liability and limiting the class of beneficiaries of fiduciary duties to shareholders. Given charter competition, no state has an incentive to change the system. Any state that broke ranks would promptly lose all significant incorporations, this being a matter on which management and shareholder interests are jointly aligned against change. The job of policing externalities accordingly goes to external legal regimes, most of them federal. Federalism questions certainly can arise respecting the level of government most appropriate for a particular regime of external regulation. But such a discussion would not implicate corporate law federalism.

Today's most salient corporate law debates devolve on the third topic. The shareholder primacy camp wants the legal structure of the firm to be revised more closely to resemble an actual (as opposed to metaphorical) agency relationship, while defenders of management discretion endorse the status quo. These debates intersect federalism at crucial points. Since the status quo favors management, those who propose revisions in the name of shareholder primacy tend to look to federal securities law as the platform for intervention.[11] Status quo endorsement accordingly invites a reference over to charter competition and state-level responsiveness to business demands. But the federalism reference determines nothing. No serious advocate of management discretion can rest the case on charter market constraints. Standing up to shareholder primacy requires an affirmative defense based on economic and governance fundamentals.

Professor Ahdieh's theoretical construct comes to bear on those economic and governance fundamentals. Let us step outside of federalism to consider its implications for corporate law more generally. Here, its contribution is descriptive. It identifies two levels of market constraint—the charter market and broader capital, product, and con-

9 *Id.* at 666.

10 *See* Winter, *supra* note 3, at 255–56.

11 Bebchuk & Ferrell, *supra* note 7, is a leading example.

trol markets—and observes that the combination of the two does not solve the problem of separation of ownership and control. The observation underscores basic assumptions already held by many in the field. Consider as an example the shareholder primacy camp's recent push to expand the set of binding shareholder votes.[12] The reform proponents, viewed from Professor Ahdieh's perspective, seek to enhance the governance impact of the capital market constraint. Meanwhile, the controversy surrounding their initiatives goes not to federalism, but to the characteristics of the capital market constraints being invoked. Professor Ahdieh anticipates this back-and-forth when he links the quality of corporate governance to capital market efficiency. Assuming the link holds,[13] the more efficient the capital market, the better the quality of the market inputs in view, and the stronger the case for reform; the less efficient the capital market, the weaker the case for reform. Interestingly, those who join Professor Ahdieh in questioning capital market efficiency will be more likely to question the case for reform. Skepticism about capital market efficiency, followed to its logical conclusion, leads to the proposition that the problem of separated ownership and control cannot be solved by law reform that empowers shareholders, and so in the end bolsters the management discretion position.

Further to this exploration of the article's implications, consider its normative objections to antitakeover regulation together with its point that the quality of corporate governance follows from the quality of capital market constraints. The juxtaposition implies that antitakeover laws should be removed, with a consequent negative implication for the federalism. But others who work from the same base of assumptions articulate a different view. They argue that actors in the capital markets responded to the imposition of antitakeover barriers by working within the governance system to reorient management incentives toward the end of cooperation with the mergers and acquisition market.[14] If this is correct, state antitakeover barriers are less important than corporate law observers usually assume because

12 *See* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005).

13 I would question the assumption that the quality of corporate governance is linked to capital market efficiency.

14 *See* Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, 15 J. ECON. PERSP. 121 (2001); Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002).

background market constraints are unexpectedly robust. This literature in effect takes Professor Ahdieh's distinctions between corporate law and corporate governance and between charter and broader market constraints to tell a story of successful market adjustment.

I will close with a *caveat.* While I readily join Professor Ahdieh in putting charter competition in a secondary place in the overall scheme of things, secondary does not mean irrelevant or trivial. State corporate law still matters, and charter competition matters with it, even if markets, contracts, and the federal securities apparatus all matter more. Once we stop jockeying over efficiency and inefficiency claims, and step out of that context to appraise the state-level institution de novo, the good outweighs the bad and competition plays a constructive role.

The good I see lies in Delaware's evolution in the wake of destabilizing events like the federal incorporation threat of the 1970s and the takeover wars of the 1980s. Its courts emerged as leading strategic players, defusing the federal incorporation threat by taking fiduciary law more seriously. In so doing, the Delaware courts experimented with and then rejected the old Berlian trust paradigm,[15] with its template of fairness review.[16] Drawing on a self-regulatory model to substitute process scrutiny, they reinvented corporate fiduciary law, making fiduciary review more compatible with both management's preferences and emerging notions of good governance. Delaware's judges at the same time emerged as leaders in ongoing discussions about governance practices, strengthening the state's tie to all of its corporate constituents. Restating this point by reference to Professor Ahdieh's distinction between governance and law, Delaware's judges emerged as national leaders in corporate governance as well as in corporate law, providing a responsive, well-informed center of gravity in both contexts. Given the claims jockeying that goes on all around them, that amounts to no mean accomplishment.

Summing up, interventions in corporate law discussions can be sorted into three types.[17] One type assumes that markets work well and that market constraints cure all ills. Any empirical evidence is

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15 William W. Bratton, *Berle and Means Reconsidered at the Century's Turn*, 26 J. CORP. L. 737, 762–65 (2001).

16 The crucial case was *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), which abandoned a regime of mandatory judicial fairness scrutiny of cash-out mergers instituted by *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), and accorded independent director determinations of transactional fairness significant weight.

17 The typology draws on comments made by Professor Andrew Metrick at the Penn Law Institute for Law and Economics Roundtable on December 12, 2008.

interpreted to fit the market frame. A second type assumes that markets do not work and that self-serving and self-dealing conduct run rampant. Any empirical evidence is interpreted to fit the market failure frame. The third type proceeds unattached to either body of prior assumptions, proceeding flexibly toward reasonable observations. Professor Ahdieh's paper falls into the third category.